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Death of a Bank

This column discusses two important truths and the role of the government in the wake of the bank failures of Silicon Valley Bank and Signature Bank.

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It has been 15 years since the 2008 "Great Recession," when the financial system was on the verge of collapse. In the wake of 2022, the worst year for Wall Street since 2008, the March 2023 failure of Silicon Valley Bank and Signature Bank, followed by the distressed sale of First Republic Bank, set off renewed fear for the health of the banking system. Did these regional bank failures signal the beginning of a greater bank panic and economic downturn? Fortunately, no. However, it does give us an opportunity to revisit how banks work and their role within our economy. As with many tragedies, it also serves as a cautionary reminder of two important truths, and allows us to consider an important existential question:

Truth 1: Incentives drive decisions.

Truth 2: Decisions have consequences.

Existential question: What is the role of government?

A run on a bank is nothing new. It is a primary plot point in the classic movie, “It’s a Wonderful Life.” A “bank run” or “run on the bank” occurs when many account holders request the full withdrawal of their money in a very short period of time because they believe the bank may fail in the near future. This was the simple cause of Silicon Valley Bank’s (SVB) collapse. What led to the run on SVB? More importantly, what can we learn?

In the United States, as in most countries worldwide, we have a fractional banking system. A commercial bank will take deposits from the public and keep record of those deposits for the account holder. The bank, in turn, will loan out the money it has received to its borrowing customers. Banks are required to keep an amount of cash deposits available to its depositors in proportion to the amount of assets that it has lent out. This is the “reserve requirement.”

Commercial banks can be private sector banks or public sector banks. Banking clients can be individuals or companies. Some banks are privately owned; others are publicly owned, meaning that they are owned by multiple shareholders who can buy and sell their bank stock.

The reason you put your money in a bank is so that you can earn some rate of return, or that your money will be available to you to pay your bills in a more convenient way. If a person has a bank savings account, the bank will pay a rate of interest to the depositor. If the account is a checking account, where the account holder typically has unlimited withdrawal capability, then there is frequently little, or no interest paid.

Because banks do not actually have all of depositors’ money on hand, there must be trust that the bank will be able to provide their money upon request. Most account holders will have a regular cycle of deposits and withdrawals. (Think of when your paycheck hits your account and when you pay your monthly bills.) The general regularity of timing involved with when money is deposited and later needs to be paid out allows the bank to keep a relatively small percentage of the value of all depositor’s balances as actual cash in the bank.

The bank will use its deposits to make loans to individuals or businesses. The interest payments made on the loans generates revenue for the bank.

A bank can also invest its deposits and reserves to generate investment revenue. As a business, a bank makes money through the interest earned on the loans it makes. It also will have revenue from fees that it charges its account holders, and by the interest or other investment return earned on its reserves.

A bank has a mandate to steward its depositors’ money. Given the critical need for banks to not steal their depositors’ money, banks must follow certain laws. However, as a business, owners of a bank will want to increase revenue and profits. In order to grow, some banks go public, and shares of their stock are available for purchase. Therefore, a publicly traded bank must also make money for its stock shareholders. Publicly traded banks essentially have competing interests: comply with banking rules and regulations as a steward for its depositors and increase revenue and shareholder value for its owners. When these two competing interests are aligned or at least in balance the bank, its shareholders, and its depositors all thrive.

Unfortunately, greed often tips the scale. Banks can generate higher revenue by making riskier investments or loans. However, a bank’s balance sheet that has too much risk associated with it can fail due to insolvency—meaning, the bank is incapable of providing all account holders with the value of their accounts. This is the reason behind most bank failures. Two days after SVB’s collapse, federal regulators closed Signature Bank, a cryptocurrency lender centered in New York. Signature Bank’s investment in cryptocurrency made the bank insolvent when faced with its own bank run by its depositors, many of whom were real-estate investors. (Real-estate investors’ deposit balances can be much higher than a retail depositor, based on their property sales. The federal regulators that closed Signature Bank cited “poor management” and chasing “rapid unstrained growth.” There is a reason why greed is not good (notwithstanding Gordon Gecko’s declaration to the contrary in the movie, “*Wall Street*”).

The Federal Reserve

The Federal Reserve Act of 1913 established the current Federal Reserve System. All banks in the United States are under the authority of the Federal Reserve (the Fed), a quasi-governmental entity, along with 12 regional Federal Reserve Banks, which are supervised by the Federal Reserve Board.

Under Title 12 of the United States Code, the Federal Reserve and the Fed regional banks have the following responsibilities:

1. To supervise and regulate banking institutions;
2. To protect the credit rights of consumers;
3. To manage the nation's money supply through monetary policy with the goal of achieving:
 - a. maximum employment;
 - b. stable prices (including prevention of inflation or deflation); and
 - c. moderate long-term interest rates.

[12 U.S.C. § 225a of Title 12 of the United States Code, <https://www.law.cornell.edu/uscode/text/12/225a>]

Following the Great Depression, the Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC), which provides deposit insurance to account holders in US commercial banks and savings banks. The insurance limit was raised in 2010 to \$250,000 per ownership category. All amounts that a particular depositor has in accounts in any particular ownership category at a particular bank are added together and are insured up to \$250,000.

Within the US banking system, there are eight very large national banks, which, after 2008, are considered “too big to fail” because their combined deposits and business activity would have a catastrophic impact to the US Economy, should they go out of business. These banks, which are JP Morgan Chase, Bank of America, Wells Fargo, Citigroup, Goldman Sachs, Morgan Stanley, BNY Mellon, and State Street, are subject to additional federal supervision and regulations.

There also are regional banks. Regional banks are smaller due to their focus on their geographic location and/or certain industries. Regional banks are an important part of the financial system because they can specialize and provide banking choices. Because the United States has many different banks, consumers have the option to use a bank based on their own priorities. For example, you can choose a bank based on their fees (what will you be charged for services), convenience (how many branches or ATMs are available to you), or customer service (do you have access to a person who is competent or will loan you or your business money?). In a system with multiple choices, consumers typically benefit, because the competition between banks will optimize the cost of services.

As part of its Monetary Policy, the Fed sets the interest rate for banks when they borrow from each other to meet their short-term needs. This is the “Fed Funds Rate.” In reaction to the great financial crisis of 2008, the Fed adopted an aggressive Monetary Policy to stimulate economic activity and restore trust in the

financial banking system. Interest rates were reduced to zero by the end of 2008 to create additional incentives for banks to make loans available for individuals to create or expand their business operations. Congress also passed legislation to mandate greater supervision of banks by the Fed. Bank stress tests were put in place to review banks' credit risk, market risk, and liquidity risk to measure the financial stability of banks in different market conditions to better safeguard depositors.

Incentive Driven Decisions and Distorted Behavior

The economy recovered from the 2008 financial crisis, but parts of the economy recovered much faster than others. Real estate prices generally recovered by late 2012, but real estate in high demand markets such as the San Francisco Bay Area and New York mostly kept their value even during the crisis. The stock market, as measured by the Dow Industrial Index, took four years to recover from the crash; the S&P 500 lost nearly half its value and took two years to recover. Unemployment was around 5 percent in 2007, rose to 9.5 percent in June 2009 and peaked at 10 percent in October 2009. It then began to fall and by December 2017, unemployment rate had fallen to 4.1 percent. Whether it motivated by political pressure, caution, or Wall Street's temper tantrums, the Fed was exceedingly cautious and slow to revert back to a more normalized Monetary Policy.

Over time, the Fed's aggressive Monetary Policy resulted in distorted behavior by banks and bank customers. When the Fed fund rate was cut to zero, normal savings accounts no longer paid interest for deposits, and individuals seeking returns on their deposits were forced to take more risk, in either the bond or stock markets. PIMCO called this “the new normal.”

Money market rates also went to zero. Companies offering money market funds were in jeopardy to “break the buck,” as the cost to offer a money market fund was more expensive than the revenue that it generated. The Securities and Exchange Commission (SEC) had to issue new rules on money market funds that started investing in non-US government bonds, and potentially took on greater investment risks.

In 401(k) plans, conservation of capital funds experienced increased demand and a shift to stable

value funds, away from money market funds, since their rates were greater than zero. This was a necessity for any 401(k) plan that had cost sharing with participants, so that a 401(k) plan's cash fund, which purported to take no risk, did not actually give a participant a negative rate of return after their service provider assessment was taken.

If an individual investor did not want to take additional market risk, there was little incentive to move cash from a bank deposit account to a CD or money market fund, as one would give up immediate access to funds for just a few basis points.

On the business side, the technology sector of the economy took advantage of easily accessible money to fund innovative businesses, and start-up companies flourished. Why not take a business risk on a new idea or innovation with a loan that carried an historically low interest rate?

For public companies, the Fed's easy Monetary Policy led to increased stock buybacks. At its most simple, a company's value is a calculation of the business's assets and revenue less its liabilities. For companies that have no assets, the company's value may be a projection of their profitability or potential to make profits over time. Market capitalization measures a publicly traded company's value by multiplying the total number of outstanding shares by the company's current share price. Stock buybacks increase the value of shares, because there are fewer shares available to the public for sale.

Decisions Have Consequences

Silicon Valley Bank was founded to serve startup companies, most of which were in the technology or biotech sectors. It aggressively pursued new clients and cross-selling other services from its strategic partners, such as payroll companies who used its banking services. According to a 2022 investor relations presentation, SVB provided banking services to almost half of US venture-backed tech and life science firms. Moreover, SVB clientele were not only startup companies, but the venture capital companies who funded them. Retail clients were commonly the highly paid employees, management teams, and founders of SVB's business clients. Technology and Biotech startups have notoriously large budgets to cover high priced engineers, research and development, and additional perks to recruit and retain their employees. SVB benefited from very large business and retail cashflows and acountholder deposits.

How much money are we talking about? According to the 2019 Federal Reserve Survey of Consumer Finances, the median transaction account balance (that is, checking account) is \$5,300. This is well below the FDIC insurance limit of \$250,000. In contrast, at the end of 2022, the average SVB customer balance was \$4.2 million. More than 37,000 separate SVB accounts exceeded the \$250,000 FDIC insurance limit.

In some ways, SVB was a victim of its own success. As its clients' startup companies raised capital from venture firms and other companies, SVB deposits skyrocketed. Banks' deposits can be loaned out to other differentiated companies and individuals. However, to comply with its capital reserve objective, SVB was unable to make enough loans relative to its deposits.

Post-2008, SVB kept within stress-test guidelines by investing its assets in government-backed bonds, which were safe relative to credit risk standards. However, they struggled to make enough loans to grow their bank revenue. To increase the yield that they received on their invested assets, they bought bonds with longer maturity periods. While these bonds had increased yields, they also had increased duration, which is the bond's sensitivity to interest rate changes. The greater the duration, the greater the yield, but also the greater the exposure to interest rate risk.

Post-COVID, as the economy reopened, the Fed needed to address inflation that was brought on by pent up consumer demand and higher prices from supply chain disruptions. In addition, the labor market tightened as retiring baby-boomers left the workforce and there were not enough workers to back-fill open positions.

In 2022, the Fed raised interest rates a record seven times. As 2023 began, SVB was caught with a portfolio of bond assets that were dramatically less valuable than they were when they were purchased. SVB shareholders, including members of the bank's management team, started to sell their stock before word spread that the bank's balance sheet was dramatically underwater. However, as we know in our Twitter world, sensationally bad news travels at light-speed. Venture capital companies and their leadership teams spread the word to their portfolio businesses to cash out of SVB stock. Retail depositors followed. SVB's share price plummeted. Despite reaching out to Goldman Sachs to help it raise capital, word spread, and a run on the bank ensued. SVB could not fulfill the withdrawal requests by its acountholders. In a dramatic two days, SVB was seized by regulators as insolvent.

The Role of Government

When Silicon Valley Bank failed on March 10, 2023, it was in the largest collapse of a US bank since the 2008 credit crisis. Following its failure, state regulators closed New York-based Signature Bank; this was the second largest bank failure. The First Republic Bank's failure surpassed both when regulators forced its sale to JPMorgan Chase on May 3, 2023.

To restore public faith and trust, President Joe Biden addressed the situation and declared that the US banking system is "safe." US regulators, in coordination with the FDIC, ensured that all SVB deposits would be returned to depositors. JPMorgan's acquisition of First Republic meant that JPMorgan would functionally guarantee depositor assets; as a result, no depositors lost any money because of the closure.

Peripheral business functions that used SVB for payroll services were (fortunately) disrupted only for one or two days. However, in today's interconnected world, clients needed to spend several days redoing their payroll file feeds and ACH wire/debit instructions, as SVB assets were moved to a new banking partner.

In contrast, the investors in SVB stock lost everything when the stock price effectively went to zero. Initial sympathy for SVB leadership for being caught by 2022's unrepresented number of Fed interest rate hikes quickly soured when it became known that they tried to sell their stock holdings prior to public disclosure of their insolvency. Pundits tempered their judgement, but universally noted that not accounting for duration risk was a sign of either incompetence or intentional ignorance.

What Can We Learn?

Generally, we want societal rules to hold those responsible for their actions accountable and minimize the collateral damage to those who are caught in middle.

There was general agreement among the investing community that the government intervention to back-stop depositor accounts was the correct action to restore public trust and prevent harm by bank mismanagement. Whether there should be a limit on FDIC insurance was also debated, and there is ongoing

discussion on what type of increased regulatory safeguards should be put in place to prevent future failures.

While not responsible for SVB management decisions, did the Fed create the environment for SVB's failure? Did the Fed's delay in raising interest rates to a level closer to their long-term average contribute to SVB's collapse? Or was there a "perfect storm" of events that caused the collapse?

The federal funds rate was 2.4 percent in March 2019. This is half of the longer term average rate of 4.6 percent between 1954 and 2023, but rates were cut down almost to zero in response to the COVID crash. The average fed funds rate has been 1.8 percent since 2018. We can speculate that the Fed was on a path to normalize rates if it wasn't for the pandemic. We could also speculate that SVB (or First Republic) would have survived if there was more time for their balance sheets to have absorbed the change in interest rates. Both are moot.

In contrast, I have no sympathy for any member of the management team or any other quasi-insider who looked to sell their stock prior to the public release of the bank's financial status. Whether or not it was actual insider trading (and merits SEC sanctions or jail time), the investment losses incurred by SVB's management team holds them accountable for their decisions. As investors, it was fair that they had the upside potential of their speculation, as long as there is risk of failure.

While SVB serves as a cautionary tale of greed and the systemic circumstances that led to it, I am thankful that the bank, as a public company, was allowed to fail. Yes, shareholders lost the money that they invested. However, investing, specifically speculation, is based on the risk of loss. When companies are not allowed to fail, a natural check on risk-taking is removed. In turn, this feeds the general distrust of markets and rule of law.

Failure is painful, but it is also one of the best teachers. It is not the role of government to protect us from ourselves. You cannot legislate good behavior. However, there is a legitimate role of government to pass laws and regulations and enforce them consistently, so that there are incentives (good and bad) that align behavior with policy objectives. ■

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